INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	1
Statute involved	2
Statement	3
Argument	5
Conclusion	10

CITATIONS

Cases:

Baltimore Steam Packet Co. v. *United States*, 180 F. Supp. 347	6
Burt Cold Storage, Inc. v. *Commissioner*, decided August 25, 1967 (26 T.C.M. 820)	9
Commissioner v. *Court Holding Co.*, 324 U.S. 331	9
Connecticut Railway and Lighting Co. v. *United States*, 142 F. Supp. 907	6
Denver v. *Denver Union Water Co.*, 246 U.S. 178	8
Helvering v. *Amer. Chicle Co.*, 291 U.S. 426	6
Hort v. *Commissioner*, 313 U.S. 28	6
Kimball Laundry Co. v. *United States*, 338 U.S. 1	8
LaBelle Iron Works v. *United States*, 256 U.S. 377	7
Memphis Transit Co. v. *United States*, 297 F. 2d 542, certiorari denied, 371 U.S. 815	6
Omaha v. *Omaha Water Co.*, 218 U.S. 180	8
Segal v. *Rochelle*, 382 U.S. 375	6
Southern Natural Gas Co. v. *United States*, Ct. Cl. No. 479–58	9

351-218—69

Cases—Continued Page

United States v. *Bess*, 357 U.S. 51 6

United States v. *Kirby Lumber Co.*, 284 U.S. 1 .. 6

Walsh Holyoke Steam B. Wks. v. *Commissioner*, 160 F. 2d 185 ..... 8, 9

Statutes:

Internal Revenue Code of 1939, (26 U.S.C. 1952 ed.): 2, 5

Sec. 714 5

Sec. 718 ..... 2, 5, 6, 7

Revenue Act of 1917, 40 Stat. 306, Sec. 207 ... 7

Miscellaneous:

Paton, *Advanced Accounting* (1947), c. XIX, Valuation of Intangibles, pp. 420–437 7

Treasury Regulations 111 (1939 Code), Sec. 29.22(a)–17 6

Treasury Regulations 112 (1939 Code), Sec. 35.718–1 8

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 1302

UNION PACIFIC RAILROAD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINION BELOW

The opinion of the United States Court of Claims (Pet. 1a–15a) is reported at 401 F. 2d 778.

JURISDICTION

The Court of Claims' decision on the cross-motions for partial summary judgment was entered on October 18, 1968. The Court of Claims denied petitioner's motion for rehearing on January 24, 1969. The petition for writ of certiorari was filed on April 23, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Where the petitioner issued, for cash, bonds which were convertible into its common stock, and the hold-

ers of the bonds subsequently exercised their conversion privilege, was the amount of money and property paid in for the stock for purposes of computing "equity invested capital" under the Excess Profits Tax the cash received on the issuance of the bonds, or was it some larger amount equal to the fair market value of the stock when issued or the fair market value of the bonds when converted or the cost basis of the bonds to the converting bondholders?

STATUTE INVOLVED

The relevant provision of the Internal Revenue Code of 1939 is:

> SEC. 718 [as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974, 982, and amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798, 911]. EQUITY INVESTED CAPITAL.
>
> (a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—
>
> (1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;
>
> (2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value

of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with repect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(*l*) for determining earnings and profits;

* * * * *

(4) *Earnings and profits at beginning of the year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

[26 U.S.C. 718.]

STATEMENT

In 1901, petitioner issued for $100 million in cash $100 million in ten-year four percent bonds convertible at the option of the holder into $100 par value common stock, par for par. During the years 1901 through 1907, holders of the bonds converted $99,450,000 principal amount of the bonds into 994,500 shares of petitioner's common stock. In computing its excess profits credit based on equity invested capital for the year 1942 and in computing its unused excess profits carryovers from 1940 and 1941, the petitioner included in money and property paid in for stock $99,450,000 on account of the issuance of the 994,500 shares of conversion stock. On audit, the Commissioner of Internal Revenue did not disturb these items. In Count XXIX of its first amended Court of Claims petition, petitioner asserted for the

first time that the Commissioner should have included in money and property paid in for this stock an additional $28.7 million, which is alleged to be the difference between the fair market value of the 994,-500 shares when issued and the par value already allowed by the Commissioner. (Pet. 2a–3a.)

The same situation exists with respect to a second issue of convertible bonds. In 1907, petitioner issued for $73,762,000 in cash $73,762,000 in twenty-year four percent bonds convertible at the option of the holder into $100 par value common stock at the rate of one share of stock for $175 face value in the bonds. During the years 1908 through 1914, holders of the bonds converted $46,926,775 principal amount of the bonds into 268,153 shares of petitioner's common stock. In computing its excess profits credit based on equity invested capital for the year 1942 and in computing its unused excess profits carryovers from 1940 and 1941, the petitioner included in equity invested capital the sum of $46,926,775 on account of the issuance of the 268,153 shares of conversion stock. On audit, the Commissioner of Internal Revenue did not disturb these items. In Count XXX of its first amended Court of Claims petition, petitioner asserted for the first time that the Commissioner should have included in money and property paid in for stock an additional $19.4 million, which is alleged to be the difference between the fair market value of the 268,-153 shares when issued and the par value already allowed by the Commissioner. (Pet. 3a–4a.)

The United States and petitioner each moved for partial summary judgment with respect to Counts

XXIX and XXX of petitioner's first amended Court of Claims petition. On October 18, 1968, the Court of Claims granted the government's motion and denied petitioner's. Petitioner's timely motion for rehearing was denied on January 24, 1969.

ARGUMENT

The decision below is correct, and there is no conflict of decisions or other basis for further review.

1. "Equity invested capital" as defined in Section 718 of the Internal Revenue Code of 1939, *supra*, p. 2, includes both "money" and "property" paid in for stock. Equity invested capital is the starting point for computing the credit Section 714 allows with respect to invested capital in the determination of the amount of income subject to the World War II excess profits tax. The single question here is the amount of money or property paid in for the stock petitioner issued upon conversion of its convertible bonds.

The holding below that the only amount includable in petitioner's equity invested capital is the cash—the "money"—which it originally received upon the issuance of its convertible bonds is not, as petitioner contends, contrary to the Code and the Regulations. As the Court of Claims concluded (Pet. 8a), "for all practical purposes," the cash received for the bonds became, on conversion of the bonds, money paid in for stock. Petitioner cites no provision of the Code or Regulations declaring that convertible bonds surrendered to the issuer for conversion constitute the "property" paid in for stock. Although bonds are property as a general proposition, the bonds here

represented petitioner's debts and their conversion added nothing to its equity invested capital except to the extent its debt was cancelled. On its balance sheet, a stock liability was merely substituted for a bonded indebtedness. "Property", always a difficult concept (cf. *Hort* v. *Commissioner,* 313 U.S. 28, 31; *United States* v. *Bess,* 357 U.S. 51, 54–55; *Segal* v. *Rochelle,* 382 U.S. 375, 379), requires in the context of Section 718 a construction that is consistent with the Congressional purpose, in subjecting war-induced profits to the excess profits tax, to exclude from equity invested capital purely fictitious values or amounts. See *Memphis Transit Co.* v. *United States,* 297 F. 2d 542 (Ct. Cl.), certiorari denied, 371 U.S. 815. Petitioner's position is entirely at odds with such an objective.[1]

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[1] Petitioner argues (Pet. 6) that, if the stock was issued for property, then the amount to be included in equity invested capital is the fair market value of the conversion stock. Even if this were correct, and if the conversion privilege should be disregarded, as petitioner suggests, petitioner is not entitled to prevail for the reason that its earnings and profits would have to be reduced for a premium paid to retire debt equal to the difference between the amount paid (the fair market value of the conversion stock) and the amount received on issuance of the bonds. Treasury Regulations 111 (1939 Code), Section 29.22(a)–17(1)(b); *Baltimore Steam Packet Co.* v. *United States*, 180 F. Supp. 347 (Ct. Cl.); *Connecticut Railway and Lighting Co.* v. *United States*, 142 F. Supp. 907, 909–910 (Ct. Cl.); cf. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1, and *Helvering* v. *Amer. Chicle Co.*, 291 U.S. 426. In short, the amount by which equity invested capital would be increased under Section 718(a)(2) would be offset entirely by the decrease in earnings and profits under Section 718(a)(4). The Court of Claims, however, did not find it necessary to reach this point.

2. Seeking to identify some contribution to capital above the cash paid in on issuance of the bonds, petitioner argues (Pet. 9–12) that the conversion effected a contribution of going concern value. This is said (Pet. 12) to be the result of the release of the lien on the physical assets[2] and the elimination of the interest charge. But going concern value is not affected by a reduction in interest charges due to the conversion of debt to equity if going concern value is to be arrived at by capitalizing excess earnings. Paton, *Advanced Accounting* (1947), c. XIX, Valuation of Intangibles, pp. 420–437. Further, *LaBelle Iron Works* v. *United States,* 256 U.S. 377, held that unrealized appreciation of assets could not be the subject of an increase in equity invested capital for purposes of the World War I excess profits tax. While that case involved the definition of invested capital under the excess profits tax in effect during World War I, the statute at issue, Section 207 of the Revenue Act of 1917, 40 Stat. 306, was for present purposes, substantially similar to 718 of the 1939 Code. Although *LaBelle* involved an attempt, through the issuance of new stock in exchange for old, to add the unrealized appreciation of real estate to the corporate equity invested capital, both *LaBelle* and this case involve the crucial fact that the issuance of stock did not result in the acquisition of any assets the corporation did not previously have. Here, as in *LaBelle,* petitioner is simply seeking to add apprecia-

[2] Conversion of the bonds issued in 1907 did not result in the release of a lien since this second issue of convertible bonds was unsecured. (Ex. 2 to Deft. Motion of March 21, 1968.)

tion in value of its corporate invested capital, and there is even less reason to allow that course here, since only petitioner's stockholders, and not petitioner itself, have the ability to realize that appreciation.

3. The three decisions of this Court on which petitioner relies, *Kimball Laundry Co.* v. *United States*, 338 U.S. 1; *Omaha* v. *Omaha Water Co.*, 218 U.S. 180; *Denver* v. *Denver Union Water Co.*, 246 U.S. 178, do not support its theory that bondholders contribute going concern value when they exercise a convertibility privilege inhering in a bond. *Kimball Laundry* and *Denver Union Water* concerned the protection extended going concern value by the Fifth and Fourteenth Amendments, the first for purposes of condemnation proceeding and the second in a rate-setting proceeding. *Omaha Water* involves a city's exercise of an option to acquire a waterworks at an appraised value. The holding that going concern value was one of the assets to be appraised and paid for was a matter of interpretation of the particular contract in issue there. Obviously none of these cases are relevant to the question here.[3]

4. The decision below is not, as petitioner asserts (Pet. 8–9), in conflict with *Walsh Holyoke Steam B. Wks.* v. *Commissioner*, 160 F. 2d 185 (C.A. 1). The

[3] Petitioner's assertion (Pet. 12–13) that equity invested capital should include the basis of the converting bondholders has no support in the statute or regulation. Section 35.718–1 of Treasury Regulations 112 (Pet. 3), on which petitioner apparently relies, deals with basis of "property" received in exchange for stock and makes no reference to the transferor's basis. At all events, the bonds were not "property" when received by petitioner, since they represented petitioner's debt which was being cancelled as part of the exchange.

Court of Claims distinguished that case on the basis that it did not involve convertible bonds (Pet. 9a). This is correct because, upon the issuance of convertible bonds, both the issuer and the subscribers anticipate from the outset the ultimate conversion of borrowed funds to equity capital. For this reason the significance of convertible bonds and the tax consequences of the conversion cannot be considered without a reference back to the facts concerning the issuance of the bonds, since, in determining the income tax consequences of a transaction, it must be viewed as a whole, and not according to its component steps or parts. See, *e.g., Commissioner* v. *Court Holding Co.,* 324 U.S. 331. On the other hand, in the situation where the conversion is not anticipated from the beginning, but occurs solely as the result of events post-dating issuance, such a reference back is unnecessary. This was the case in *Walsh Holyoke,* where there was a scaling down of indebtedness through the issuance of new stock and debt for old defaulted debt in an insolvency recapitalization.

5. The issue here involves a moribund provision of the Internal Revenue Code. We are aware of only one other case pending in the courts involving a World War II excess profits tax issue,[4] and it has no con-

[4] In *Burt Cold Storage, Inc.* v. *Commissioner*, decided August 25, 1967 (26 T.C.M. 820), pending on appeal (C.A. 2), the taxpayer disputes the correctness of assessments of excess profits tax for its fiscal years ending June 30, 1942, through 1946, but the issues pertain to the computation of net income and penalties for fraud and failure to file returns. In *Southern Natural Gas Co.* v. *United States*, Ct. Cl. No. 479–58, the Government conceded the only excess profits tax issue. Trial Commis-

nection to the question in this case. Under these circumstances, the issue does not have sufficient general significance to warrant further review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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sioner's report of January 23, 1969 (1969 P-H Federal Taxes, par. 58,029), as to which both parties have withdrawn their exceptions.

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